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290940Z Sep 03

C O N F I D E N T I A L SECTION 01 OF 03 COLOMBO 001686

SIPDIS

DEPT PLEASE PASS TO E, EB, SA/INS, SA/RA, DRL
DEPT ALSO PASS TO USAID FOR BERNADETTE BUNDY - ANE/SA
DEPT ALSO PASS TO USTR FOR AUSTR WILLS
TREASURY FOR JERRY ADKINS
DOL FOR SUDHA HALEY
NSC FOR ELIZABETH MILLARD
COMMERCE FOR ARIADNE BENAISSE
TOPEC

E.O. 12958: DECL: ONE YEAR AFTER CONCLUSION OF US-SL FTA
TAGS: [ETRD](#) [EAID](#) [ECON](#) [EFIN](#) [KIPR](#) [ELAB](#) [PREL](#) [CE](#) [ECONOMICS](#)
SUBJECT: FTA IMPLICATIONS OF SRI LANKAN INVESTMENT CLIMATE

Ref: a) Colombo 1673, b) Colombo 1386, c) Colombo 772

1. (U) Classified by Ambassador Jeffrey J. Lunstead for reasons 1.5 B and D.

2. (C) Summary: The investment climate in Sri Lanka is improving and the GSL is committed to economic reforms and attracting more capital as the island continues its efforts to restore peace and prosperity. The Indo-Lanka FTA, increasing interest of major U.S. companies, and efforts by the GSL and the private sector to diversify exports and improve competitiveness are indicators of a government we can work with in forging a closer bilateral trade relationship. Challenges remain, however, and one avenue for our influence is through FTA negotiations. USAID is already involved in several areas of capacity building and economic reform and has indicated it could do more in the lead up to FTA negotiations. End Summary

Investment Climate

3. (U) The investment climate in Sri Lanka is improving and well poised to take advantage of a potential US-SL FTA (Ref A). GSL emphasis on free trade and bilateral FTAs has spurred interest in foreign investment. U.S. and other foreign investment is steadily climbing upward (admittedly from a very low base). Private sector interest is increasing in the power, IT, telecom, infrastructure and financial services sectors and the GSL is actively soliciting additional investment in these areas. The Indo-Lanka Free Trade Agreement has led to some increased investment in SL as a production point for the Indian market (Ref C). There is great potential for US firms to reach the huge Indian market through Sri Lanka at greatly reduced, even zero, tariff rates. FTAs with Bangladesh and Pakistan are reportedly also in the offing.

4. (U) Increasing interest in Sri Lanka on the part of global investors and the GSL's sound fiscal policies, are having an overall positive effect on the economy. Inflation has shown a sharp decrease this year (latest estimates are approximately 6.5 percent, down from 9 percent a year ago). The central bank has further reduced interest rates and the currency has strengthened, with a three percent appreciation in the last two months. Projected GDP growth is estimated to be somewhere between 5.5 and 6.5 percent for the year. Finally, the budget deficit appears to be on track for hitting its target of 7.5 percent of GDP.

5. (SBU) However, major problems have not yet been eliminated. Regulatory barriers, corruption and a lack of transparency, as well as general bureaucratic hassles (due in part the proliferation of ministries - over 75 and counting), continue to plague the investment process. Further, the GSL currently keeps tremendous responsibility and decision-making authority in a tiny inner circle surrounding the PM. This causes significant decision-making bottlenecks and creates a serious transparency issue. Devolution of decision-making authority and responsibility, along with regulations and reforms to help insulate decision makers from political influence - while still protecting the integrity of the process - are imperative. The government procurement process is slow and opaque, lacks technical capacity and is subject to political and personal influences.

6. (C) As mentioned in previous reporting (Ref A), U.S. companies such as Microsoft, Dell, Honeywell, Program Development International, Bechtel, Lockheed Martin, GE and Caterpillar are seriously looking at Sri Lanka or are already present in the market. The potential for investment in infrastructure and market development programs over the next five to ten years is over USD 5

billion.

17. (C) On the other hand, the January 2005 expiration of the Multi-Fiber Agreement (MFA) looms large, and Sri Lanka believes that only a FTA with the US will help offset the negative effects on the garment industry. The rationale is clear; 68 percent of Sri Lanka's garment exports are to the US. Best estimates are that Sri Lanka's garment industry will consolidate significantly. Those companies that have focused on the high-end specialty garment markets will survive and, potentially, thrive while smaller, general merchandise factories will close or merge. The GSL is also attempting to diversify its exports to end its reliance on the garment sector.

18. (C) Many of Sri Lanka's garment manufacturers have begun the transition to insulate themselves against the end of the MFA. The Joint Apparel Association specifically is promoting a move to high-end, specialized garments, improved efficiency, introduction of new manufacturing techniques and is offering assistance to factories seeking ways to become more competitive in the post-MFA world. We recognize that an FTA would not allow 100 percent duty-free entry of all garments, but the GSL will be sure to push hard on garments in any FTA negotiations.

Economic Reforms

19. (C) The GSL is committed to the economic reform process and continues to make headway - particularly in the areas of debt management, monetary policy and macroeconomic stabilization. In the past two years, the GSL has implemented promising changes in many areas. It has made upward adjustments of utility, transport, wheat flour and fuel prices and eliminated subsidies. One hundred percent foreign ownership is now allowed in formerly restricted sectors, including banking, insurance, finance, supply of water, mass transport, telecom and professional services. Long-term debt instruments have been added and incentives offered to investors under the Board of Investment were restructured and reduced. Civil service recruitment was frozen. Some licensing controls on agricultural products were removed. The tax system was reformed with the introduction of a VAT in August 2001, a tax on bank debits and interest and a reduction in the import duty surcharge.

10. (C) While progress has been made on privatization, it proceeds at a slow and uneven pace. Contract enforcement mechanisms are a weak spot and revenue collection needs more improvement. Several areas of reform are under review, including land, labor laws, banking and regulatory issues.

11. (C) The GSL also will benefit from considerable outside expertise in the reform arena. This is true particularly with regard to:

- the budget process and debt management (through U.S. Treasury Advisors),

- investment (via an UNCTAD consultant on investment),
- the financial services sector (through new laws and policies aimed at deepening the financial sector and the creation of a stronger secondary debt market) and

- competitiveness policy (via the USAID sponsored competitiveness initiative).

12. (C) The GSL is committed to making many of the tough decisions necessary to move forward with economic reform, setting the right tone as capital comes looking for a place to invest. While there are still areas that need to be improved, our influence can have a powerful effect, and our interests would be well served by engaging on many of these topics through the mechanism of FTA negotiations as outlined in Ref A.

LUNSTEAD